Supreme Court, U. S.
FILED
JUL 28 1980
MICHAEL RODAK, JR., CLERK

80-128

No. .....

In the Supreme Court of the United States

October Term, 1980

INVESTORS RESEARCH CORPORATION

AND

JAMES E. STOWERS,

Petitioners,

vs.

SECURITIES AND EXCHANGE COMMISSION,

AND

RICHARD H. DRIEHAUS,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

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QUESTIONS PRESENTED

1. Whether, in an SEC disciplinary proceeding, a violation of Section 17(e)(1) of the Investment Company Act of 1940 must be proved by clear and convincing evidence rather than by a preponderance of the evidence.

2. Whether a violation of Section 17(e)(1) of the Investment Company Act of 1940 is proved by a showing that an affiliated person of an investment company accepted payment from a broker for a computer service, and absent any showing that the payments were compensation for the purchase or sale of property to or for such company.

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STATUTE

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vs.

SECURITIES AND EXCHANGE COMMISSION,

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RICHARD H. DRIEHAUS,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

Petitioners, Investors Research Corporation and James E. Stowers, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the District of Columbia is not yet officially reported, and is reproduced at page A1-A22 of the Appendix. The order amending the opinion is reproduced at pages A23-A25 of the Appendix. The opinion of the Securities and Exchange Commission is unofficially reported at Fed. Sec. L. Rep. (CCH) paragraph 81,586 (1978) and is reproduced at pages A27-A41 of the Appendix.

JURISDICTION

The judgment of the Court of Appeals was entered April 29, 1980, and the order amending the judgment on June 11, 1980. The jurisdiction of this court is invoked under 28 U.S.C. Section 1254(1).

STATUTE INVOLVED

Section 17(e)(1) of the Investment Company Act of 1940, 15 U.S.C. §80a-17(e)(1) provides as follows:

> (e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person —
>
> > (1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; . . .

STATEMENT

Petitioner Investors Research Corporation ("Research") is an investment adviser registered with the Securities and Exchange Commission. At all times relevant hereto its only customer was Twentieth Century Investors, Inc. ("Twentieth Century"), a mutual fund registered as an investment company under the Investment Company Act of 1940. Petitioner James E. Stowers ("Stowers") was president and the controlling shareholder of Research. Stowers was Research's portfolio manager and made all of the investment decisions for Twentieth Century.

By 1972 Stowers had developed great confidence in the abilities of a broker, Richard Driehaus.[1] Stowers placed most of Twentieth Century's portfolio brokerage with the brokerage firms with which Driehaus was associated. For some months prior to August, 1973 Stowers developed a methodology for spotting undervalued stocks. To administer his method effectively, an affiliate of Stowers and Research leased a computer and Stowers wrote a program for it. In August, 1973 he entered into a contract with a brokerage firm, Mullaney, Wells & Co., the employer of Driehaus, whereby the information from the computer was furnished to it. The information proved valuable to the brokerage firm. In return the broker paid Research $15,000 at the execution of the contract representing cost of hardware already incurred, and $6,000 per month thereafter for the actual out-of-pocket cost of the hardware. Research paid all other costs of the operation of the system. The

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1. Driehaus was also disciplined by the SEC and petitioned the Court of Appeals for review. His was a companion case with that of the petitioners here. The Court of Appeals vacated the Commission's order as to him and remanded his case to the Commission.

SEC found by a preponderance of the evidence[2] that the payments from the broker to Research violated Section 17(e)(1) of the Investment Company Act;[3] that the payments enmeshed Research and Stowers in a conflict of interest prohibited by the Act;[4] that all that the Commission need prove to show a violation of Section 17(e)(1) is a relationship that could becloud the judgment of Stowers,[5] i.e. the payments without more constitute a violation of the Act. The SEC found that Section 17(e)(1) of the Act required Mr. Stowers to avoid conflicts and that whether or not he actually engaged in conduct harmful to Twentieth Century was irrelevant.[6] The Commission further found that the record supports the view of petitioners that Twentieth Century benefitted from the arrangement and that the petitioners' belief that Twentieth Century benefitted from it was sincere,[7] that the arrangement was not a garden variety kickback case in which an investment company's manager and its portfolio broker concoct some fraudulent scheme for the sole purpose of lining their own pockets at the shareholders' expense and that it was not a "cunning device" fashioned for the sole purpose of advancing the interests of those who invented it.[8] Because of such mitigating circumstances the Commission set aside the more severe sanctions imposed by the Administrative Law Judge and censured the petitioners.[9] Petitioners petitioned the United States Court of Appeals for the District of Columbia, which affirmed the Commission's order.

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2. Footnote 30 at A42.
3. A32-33.
4. A31.
5. A35-36.
6. A37.
7. A41.
8. A41.
9. A32, 42.

The Court of Appeals Held That the Commission Correctly Based Its Findings on a Preponderance of the Evidence Instead of Clear and Convincing Evidence, and the Issue Is an Important Question of Federal Law Which Has Not Been but Should Be Settled by This Court.

In *Collins Securities Corporation v. SEC*, 562 F.2d 820 (C.A.D.C. 1977) the Court of Appeals held that in the circumstances of that case, the SEC was required to prove its case by clear and convincing evidence rather than by a mere preponderance of the evidence. In this case the Commission found *Collins* inapplicable. The Court of Appeals (A13-14) stated:

> "We also reject petitioner's assertion that the Commission improperly applied a 'preponderance of the evidence' standard of proof to this action, rather than a higher 'clear and convincing' standard. The higher standard is not mandated by Collins Securities Corp v. SEC, 562 F.2d 820 (D.C.Cir. 1977), the case petitioners rely on. *Collins* required a higher standard in *fraud* actions where a *severe sanction* is imposed. Since neither one of these elements is found in this case, *Collins* is inapplicable." (Emphasis by the Court).

On April 28, 1980, the Court granted certiorari in *Steadman v. Securities and Exchange Commission*, 603 F.2d 1126 (CA 5, 1979), cert. granted, Dkt. 79-1266. The issue in that case is whether, in SEC disciplinary proceedings, a violation of the anti-fraud provisions of the securities laws must be proved by clear and convincing evidence, rather than by a preponderance of the evidence. The petition for certiorari asserts that there is a conflict between *Collins, supra,* and *Whitney v. Securities and Exchange Commission*, 604 F.2d 676 (C.A.D.C. 1979) on the one hand, and *Steadman* on the other hand. This case presents another

important corollary of the same question. If the issue in this case is left open in *Steadman*, the question will be only half answered, and the SEC, targets of SEC investigations, counsel and the courts will remain uncertain of one of the most elementary and important rules with which they are expected to comply. The question is critical to the orderly administration of the securities laws.

The attempt by the Court of Appeals to distinguish this case from *Collins* on the grounds that this is not a fraud case will not stand. First of all the reference in *Collins* is not to a fraud case but to an "alleged fraud type" case.[10] And in *Whitney* the Court of Appeals stated that it intended the word "fraud" not merely in its common law sense but comprehending all violations of Section 10(b) and rule 10(b)-5.[11] And in *Addington v. Texas*, 441 U.S. 418, 424, 99 S.Ct. 1804, 1808 (1979) this Court stated:

> "One typical use of the standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof."

This is obviously a "fraud type" case. Here the Commission, affirmed by the Court of Appeals, has publicly impugned the integrity of the petitioners. It has maligned and humiliated them. It has found them guilty of violating an anti-kickback statute, i.e. performing a morally reprehensible act. It charges them with a "deplorable

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10. 562 F.2d at page 821.

11. 604 F.2d at page 681, fn. 19.

lack of fiduciary sensitivity."[12] The Commission has said that such arrangements "may constitute fraudulent acts and practices by fiduciaries."[13] A violation of Section 17(e)(1) has been said to involve "a breach of fiduciary duty akin to if not a species of fraud."[14]

The attempted distinction by the Court of Appeals that censure may be a less severe penalty than a suspension should not be determinative, as the Court of Appeals itself recognized in *Whitney*,[15] when it said:

> ". . . we hold here that *any* sanctions imposed under Section 15(b) which depend on a finding of fraud must be sustained by clear and convincing evidence. Such proceedings are invariably subject, in varying degrees, to the uncertainties of circumstantial and subjective proof, and *result in stigmatizing the defendant irrespective of the formal sentence meted out.*" (Emphasis added).

Thus the Court of Appeals recognizes that censure is a severe penalty, because of the stigma it inflicts on the petitioners. Both personally and professionally petitioners have been seriously injured by official and public censure. For people whose profession is to manage other people's money, there are few worse charges that could be made than that they displayed "a deplorable lack of fiduciary sensitivity." As the American Bar Association has observed, "(A good name) is a priceless asset; once (that) is lost, the lawyer carries a grave liability."[16] The aspersions cast on petitioners' integrity has caused them a loss

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12. A41.

13. Exchange Act Release No. 12251, March 24, 1976.

14. John P. Decker, CCH Fed. Sec. Law Rep. §81388.

15. 604 F.2d at page 681.

16. ABA Standards Relating to the Defense and Prosecution Function, Introduction, 14 (Official Draft, 1971).

of business which is incalculable. Although the sanction of censure is the lightest one in the SEC's arsenal, the finding of guilt is serious, damaging and even devastating in its effect.

Finally, whether or not the higher standard of proof should be imposed should be judged not with the particular sanction meted out at the conclusion of the trial and a subsequent appeal, but with the "arsenal of sanctions available" to the SEC.

> "The standard of proof to which the agency is held must in substantial measure be commensurate both with the nature of the proof and the arsenal of sanctions available to the agency; in this case, the standard of 'clear and convincing evidence' serves this function of drawing a realistic correlation between the burden of persuasion and the available remedies."[17]

The Court of Appeals, as stated above, stated in *Whitney* that *Collins* was applicable to "any sanction" "irrespective of the formal sentence meted out."

The idea that the possible maximum sanction is controlling of basic trial procedures is a familiar one. This Court has held, for example, that both the right to trial by jury[18] and the right to counsel[19] are determined by the potential penalty, not by the one actually meted out.

There are sound practical reasons, of course, for establishing such basic rules at the outset of the trial, rather than leaving them in a state of uncertainty. For example, on a clear and convincing standard, a respondent might elect, at the conclusion of the government's case, to forego the expense of putting on a lengthy defense, while

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17. *Collins*, 562 F.2d at 826.
18. *Duncan v. Louisiana*, 391 U.S. 145, 88 S.Ct. 1444 (1968).
19. *Argersinger v. Hamlin*, 407 U.S. 25, 92 S.Ct 2006 (1972).

by a preponderance standard the same respondent might feel compelled to go forward, despite a weak case achieved by the government. However, if the standard itself is in doubt, because variable with the penalty, such an election could not be made.

If this Court rules that the heavier burden applies in *Steadman* but leaves the opinion of the Court of Appeals here standing alongside and in conflict with the language and rationale of *Addington, Collins* and *Whitney* the law will remain confused and contradictory in an area which litigants going into a hearing should know with certainty. This case gives the Court the opportunity to resolve the conflict and the uncertainty.

The Court of Appeals Held That the Commission Correctly Imposed a Conclusive and Irrebutable Inference of Guilt Upon the Petitioners Because the Court Held That a Violation of Section 17(e)(1) of the Act Was Proved Merely by Showing the Payments From the Broker to Research Without Showing That the Payments Were for the Forbidden Purpose i.e. "For the Purchase or Sale of Any Property to or for" Twentieth Century. The Issue Is an Important Question of Federal Law Which Has Not Been, but Should Be, Settled by This Court.

The Commission, affirmed by the Court of Appeals, begins its analysis with the statement that the arrangement between Research and the broker created a conflict of interest which could impair petitioners' judgment, but it expressly refused to find that their judgment was in fact impaired, stating that perhaps Stowers rose above these temptations.[20] Then the Commission states that the ar-

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20. A37.

rangement was presumptively suspect and that petitioners were required to show affirmatively that none of the money paid to them was a kickback and that petitioners must show that the computer had a fair market value sufficient to warrant the conclusion that all the money paid for it was for that purpose and not a kickback.[21] Next the Commission found that the nexus between the payments from the broker to Research, and Research's direction of the brokerage to the broker "was so close as to compel the inference that the payments were for a single package."[22] and that even if the petitioners were to prove the market value of the system, a sale even at fair market value is of economic benefit to the seller and therefore constitutes the forbidden compensation.[23] In short, no matter what the petitioners proved about the value of the system (and petitioners did introduce substantial evidence of such value) it was impossible for them to rebut the SEC's presumption of their guilt. Thus the Commission has no burden of proof on any standard to show that the payments were for the purchase or sale of property to or for the investment company. The burden imposed upon the petitioners was to prove their innocence and, upon analysis, it becomes apparent that the burden could never be sustained because of the irrebutable presumption of their guilt.

Thus the Commission, affirmed by the Court of Appeals, held that Section 17(e)(1) is a conflict of interest statute, that its violation may be proved by showing a conflict of interest without more; i.e., the Commission and the Court converted Section 17(e)(1) from an anti-kickback statute to a conflict of interest statute.

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21. A38.

22. A39.

23. A40, footnote 28.

Petitioners' complaint is not so much with the shift to petitioners of the burden of explaining the purpose of the payments, but with the holding that the burden was one they could not carry, no matter what their proof. The Commission stood mute, disbelieved credible evidence and presumed the conduct of the petitioners to be unlawful.

> "No agency is authorized to stand mute and arbitrarily disbelieve credible evidence. Except as applicants for a license or other privilege may be required to come forward with a prima facie showing, no agency is entitled to presume that the conduct of any person or status of any enterprise is unlawful or improper."[24]

The Commission framed the issue before it as follows:

> "Research was selling Stowers system to Mullaney at the very same time that Research was directing virtually all of Twentieth Century's portfolio brokerage to that firm. Did this enmesh Research and Stowers in a conflict of interest prohibited by the Investment Company Act?"[25]

Thus the Commission at the outset improperly framed the issue and misdirected its inquiry by examining the evidence for a conflict of interest instead of the acceptance by Stowers and Research of compensation for the purchase or sale of property to or for Twentieth Century, i.e., a kickback. In so holding "the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning."[26]

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24. Senate Report No. 752, 79th Congress, First Session, 22 (1945) reprinted in Senate Document 248 at 208.

25. A31.

26. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375 (1976).

In *Aaron v. Securities & Exchange Commission*, ... U.S. ....., ... S.Ct. ..... (1980), this Court stated:

> "Though cognizant that 'Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes' . . . the Court has also noted that 'generalized references to the 'remedial purposes' of the securities laws 'will not justify reading a provision' more broadly than its language and statutory scheme reasonably permit' . . . Thus if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary to examine additional considerations of policy that may have influenced the lawmakers in their formulation of the statute."

The Commission held that the payments from the broker to Research "created a situation squarely covered by Section 17(e)(1)'s words and by the basic policy that the authors of those words sought to implement." That is to say, the Commission held that the payments violated the statute regardless of whether they were for the computer, or whether they were for the sale or purchase of property to or from the fund. By so holding, the Commission ignored the words of the Act. The payments must be for a particular purpose, the purchase or sale of property to or from the fund, and that purpose must be proved before the petitioners can be found guilty. By ruling petitioners' proof to the contrary to be irrelevant, the Commission and the Court excised from the Act the words "for the purchase or sale of any property to or for such registered company." The illogical nightmare into which the Commission's holding leads becomes quickly apparent. Thus the petitioners are barred from proving their innocence. They

are censured despite the fact that "perhaps" they rose above the temptations to overreach the fund, despite the fact that this is not a garden variety kickback case in which the petitioners lined their own pockets at the expense of the shareholders, despite the petitioners' sincere belief that their acts were beneficial to the fund and despite the fact that the record lends support to their view, and despite the fact that their beliefs were entertained in good faith and that the case is not one of a cunning device fashioned for the sole purpose of advancing the interests of those who invented it, and despite the fact that their record is unblemished. In short, the petitioners stand condemned, their reputations forever tarnished and their business damaged, not because they did anything morally wrong, but because they might have done something wrongful if they had thought about it. Such a conclusion does not comport with Section 17(e)(1) or with ordinary common sense.

A decision of this Court is required to restore to Section 17(e)(1) the words which the Commission and the Court of Appeals have removed from it.

CONCLUSION

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A

REC'D MAY 9 1980

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 78-1589

INVESTORS RESEARCH CORPORATION

and

JAMES E. STOWERS, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

No. 78-1597

RICHARD H. DRIEHAUS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

Petition For Review of an Order of the Securities and Exchange Commission

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Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Argued September 28, 1979

Decided April 29, 1980

Irving Kuraner, for petitioner in No. 78-1589.

Monroe H. Freedman, for petitioner in No. 78-1597.

Jacob H. Stillman, Associate General Counsel, Securities and Exchange Commission with whom *William A. Dietch*, Assistant General Counsel, *Rosalind C. Cohen*, Special Counsel, Securities and Exchange Commission were on the brief, for respondent.

Leonard J. Theberge was on the brief for Amicus Curiae urging the order of censure to be vacated.

Also *Judson H. Gould* entered an appearance for appellant in No. 78-1597.

Also *Alan Rosenbalt*, Attorney, Securities and Exchange Commission entered an appearance for appellee.

Before: WRIGHT, *Chief Judge*, BAZELON, *Senior Circuit Judge* and TAMM, *Circuit Judge*

Opinion for the Court filed by *Senior Circuit Judge* BAZELON.

BAZELON, *Senior Circuit Judge*: Petitioners Investors Research Corporation ("Investors Research"), James Stowers, and Richard Driehaus seek review of a Securities and Exchange Commission order censuring them for violating section 17(e)(1) of the Investment Company Act of 1940.[1] We affirm the Commission's order as to

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[1] 15 U.S.C. § 80a-17(e)(1) (1976). Section 17(e)(1) provides:

> (e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—
>
> (1) acting as agent, to accept from any source any compensation (other than a regular salary or

petitioners Stowers and Investors Research, but as to petitioner Driehaus, who was found liable for aiding and abetting the principal violation, we vacate the Commission's order and remand for further consideration of the question of scienter.

I. Background

A. *The Facts.*

The Commission's findings of fact, which are fully supported by the record, are as follows:

Twentieth Century Investors, Inc. ("Twentieth Century" or "the Fund"), is a mutual fund registered under the Investment Company Act which since 1958 has been managed by petitioner Investors Research. Petitioner Stowers is the president, portfolio manager and majority stockholder of Investors Research, as well as president of Twentieth Century.[2] In this joint capacity, Stowers attends to the day-to-day management of the Fund, including the selection of brokerage firms to execute the Fund's portfolio transactions. Petitioner Driehaus is a broker, and during the period relevant to this proceeding was associated with three different brokerage firms working for Twentieth Century: A.G. Becker & Co. ("Becker & Co."); Mullaney, Wells & Co. ("Mullaney, Wells"); and Olde & Co.[3]

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wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker.

[2] Joint Appendix (J.A.) 14-15.

[3] From the Spring of 1968 until July 1973, Driehaus was employed by Becker & Co. as a stockholder and later as assistant vice president. J.A. 277-88. In August 1973, Driehaus left Becker & Co. to join Mullaney, Wells, where he served as a director and also held a twelve to fifteen percent

In 1970, when Investors Research and Stowers first became Twentieth Century's portfolio managers, as many as twenty different brokerage firms executed transactions for the Fund.[4] One of these firms was Becker & Co., whose account with Twentieth Century was handled by petitioner Driehaus. During the next three years, a close professional relationship developed between Stowers and Driehaus, and an ever-increasing amount of the Fund's business was directed to Becker & Co. By August of 1973, the great majority of Twentieth Century's portfolio transactions were executed by Becker & Co.[5]

At the same time, Stowers and Driehaus were experimenting with techniques to identify undervalued securities. They soon found that the method of analysis which they deemed useful could not be performed efficiently by hand or with small calculators. Stowers determined that a computer would be necessary, and though he had no prior experience in computer operations, set out by himself to develop a computer system. He studied programming, contracted with International Business Machines, Inc. ("IBM") for the necessary hardware, and by the summer of 1973 completed a system consisting of 30 programs and a data bank containing information on some 6500 stocks.[6]

To create his system, Stowers was required to pay IBM $15,000 in development costs, and also faced monthly

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equity interest. In August 1974, when Olde & Co. took over Mullaney, Wells' accounts, Driehaus transferred to Olde & Co. J.A. 99-102.

[4] J.A. 71, 223.

[5] In 1971, Becker & Co. received 47.9% of the total commission dollars paid by the Fund, and executed 75.3% of the Fund's total principal transactions. By August 1, 1973, Becker & Co. received 95% of the total commission dollars and 86.5% of the total principal transactions. J.A. 474.

[6] J.A. 35, 413.

operating costs of $6000.[7] He informed Driehaus that he needed someone to offset this financial burden, and persuaded him to assist in approaching Becker & Co. to purchase access time to the system. Despite their combined efforts, however, Becker & Co. rejected Stowers' offer on the ground that the system would not be of value to its business.[8] Shortly thereafter, Chicago Corporation, another broker-dealer, rejected a similar offer by Stowers.[9]

Mullaney, Wells, which at the time received very little of Twentieth Century's business, was the third brokerage firm contacted by Stowers. In July 1973, Stowers met with John Kieft, an officer and director of Mullaney, Wells, ostensibly for a demonstration of Stowers' computer system. Kieft later testified, however, that from the point of view of his firm, a principle purpose of the meeting was to secure the Fund's brokerage business.[10] During this "demonstration," in fact, Stowers gave Kieft lengthy and detailed instructions concerning the manner in which Twentieth Century's orders were properly executed.[11]

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[7] J.A. 26-27.

[8] J.A. 30.

[9] Stowers testified before an administrative law judge that Chicago Corporation was "very impressed" by the system, but was unwilling to pick up the initial $15,000 costs of the computer. J.A. 31-32. He conceded, however, that Chicago Corporation asked him "how much brokerage business they were going to get [from Twentieth Century] if they bought [the system]." Stowers claims he replied that the system was unrelated to placement of the Fund's business. J.A. 31-32.

[10] J.A. 258.

[11] Stowers testified that he instructed Kieft to place transactions on either an agency or a principal market maker basis only. Kieft was also shown a copy of the Fund's prospectus, and was instructed as to how certain portions should be

Stowers' discussions with Mullaney, Wells bore fruit on August 1, 1973, when Mullaney, Wells agreed to pay Stowers and Investors Research $15,000 initially, and continuing monthly payments of $6000, professedly for access to the computer system.[12] On the same day, Dreihaus left Becker & Co. to become research director for Mullaney, Wells, where he was given full responsibility for handling the Twentieth Century account.[13] Thereafter, virtually all of the Fund's brokerage business was moved by Stowers to Mullaney, Wells, quickly making Twentieth Century the brokerage firm's largest and most important customer.[14] Mullaney, Wells, in turn, remained Stowers' only computer customer, since all further efforts to sell access to the system were unsuccessful.[15]

Despite the profitability of its Twentieth Century account, Mullaney, Wells soon found itself in precarious financial condition. Setbacks in other parts of its business forced the firm to reduce salaries, cancel subscriptions to publications, and otherwise attempt to hold costs

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worded. Various problems which the Fund had been having with the SEC were also discussed. In general, Stowers testified that he duplicated the instructions under which Becker & Co. had been operating. J.A. 219-221.

[12] J.A. 43.

[13] J.A. 99.

[14] Between August 1, 1973, and December 31, 1973, Mullaney, Wells received 97.6% of the total commission dollars paid out by the Fund and placed 100% of the Fund's total principal transactions. In 1974, Mullaney, Wells received 100% of the total commission dollars paid by the Fund, and placed 99.1 percent of its total principal transactions. J.A. 474. Stowers testified that prior to August 1973, "very little" of the Fund's business went to Mullaney, Wells. J.A. 34.

[15] Stowers attempted to sell computer services to a number of other brokerage firms, banks, mutual funds, and other institutions which might have desired access rights, but none were willing to pay for the services. J.A. 58-60.

down.[16] Yet its payments to Investors Research did not cease. Indeed, Mullaney, Wells continued paying for the computer services, and receiving the Fund's brokerage business, until the firm's deteriorating financial condition forced it out of business on August 12, 1974.[17] On this date, Olde & Co. took over Mullaney, Wells' accounts, including the Twentieth Century business, and hired Driehaus as a broker.[18] It also commenced paying Investors Research $6000 per month—like Mullaney, Wells, ostensibly for computer services.[19]

B. *Proceedings Below.*

On April 22, 1975, the Commission ordered public proceedings to investigate a variety of potential securities law violations by petitioners,[20] including the instant violation of section 17(e)(1) relating to the computer leasing arrangement. An administrative law judge, in fact, found petitioners liable under several anti-fraud statutes as well as the Investment Company Act.[21] As a sanction

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[16] The firm had been involved heavily in the municipal bond market, which experienced severe declines. J.A. 259.

[17] J.A. 101.

[18] *Id.*

[19] *Id.*

[20] In the Matter of Investors Research Corporation, *et al.* Order for Public Proceedings, File No. 3-4669 (April 22, 1975), J.A. 1.

[21] Petitioners were each found to have violated section 17(a) of the Securities and Exchange Act of 1933, 15 U.S.C. § 77q (1976) (fraudulent securities transactions), section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), and Rule 10b-5 thereunder (use of any "manipulative or deceptive device" in connection with a securities transaction), section 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1976) (fraud by an invest-

for these violations, the ALJ ordered the revocation of Investors Research's registration as an investment adviser, and Mullaney, Wells' registration as a broker dealer. He also barred Stowers and Driehaus from ever associating with any broker-dealer or investment adviser again.[22]

The Commission's Opinion

On review, the full Commission reversed the ALJ's rulings under the anti-fraud statutes, but affirmed the findings—though not the sanctions—under section 17(e)(1).[23] The crux of the Commission's theory was that the payments from the brokerage firms to Investors Research, ostensibly for computer services, were at least in part compensation for the placement of Twentieth Century brokerage business with the firms. As such, the Commission held the payments were "compensation . . . for the purchase or sale of any property to or for [a] registered [investment] company" prohibited under section 17(e)(1).

The Commission began by noting that "had [the computer leasing arrangement] been a simple two-sided relationship" between a mutual fund and its brokers, there

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ment adviser), and section 17(e)(1) of the Investment Company Act, 15 U.S.C. § 80a-17(e)(1) (1976).

In addition to the present petitioners, the parties in the administrative proceedings included Mullaney, Wells and Olde & Co. Prior to the decision of the ALJ, Olde & Co. consented to the imposition of a sanction. *See* Securities and Exchange Act Release No. 11952 (Dec. 24, 1975), 8 SEC Docket 895. Mullaney, Wells was found to have violated section 17(a) of the 1933 Act by the ALJ, and did not appeal that ruling to the Commission. *See* Securities and Exchange Act Release No. 11952 (Dec. 24, 1975), 8 SEC Docket 895 .

[22] J.A. 317-19.

[23] In the Matter of Investors Research Corporation, *et al.*, File No. 3-4669 (May 1, 1978) (hereinafter "SEC Opinion") at 3, n.12 (J.A. 341-351).

would be nothing in section 17(e)(1) to prohibit it.[24] The Fund would receive the benefits of the transaction, and no conflict of interest would arise. The "complex, three-sided" relationship in the instant case, however, was a different matter.[25] Its flaw rested in the diversion of the benefits of the transaction, *i.e.*, the payments for the computer services, to a third party, Investors Research, while the burdens, *i.e.*, the commissions and spreads that Mullaney, Wells collected from Twentieth Century, were borne by the Fund's shareholders. As the Commission stated:

> This divorce of benefit from burden created a situation squarely covered by Section 17(e)(1)'s words and by the basic policy that the authors of those words sought to implement. That policy was, as the Court of Appeals for the Second Circuit has said, "to prevent affiliated persons from having their judgment and fidelity impaired by conflicts of interest." [26]

The Commission reasoned that once this triangular relationship was created, Stowers was unable to choose the Fund's brokers with complete objectivity as the statute demands.[27]

The Commission next responded to petitioners' claim that the payments made by the brokerage firms were attributable solely to the purchase of computer services, and hence could not be "compensation . . . for" the Twentieth Century brokerage business. The Commission held that the "symbiotic relationship" between the Fund, the Investment Advisers and the brokerage firms was "presumptively suspect," and as such, the burden was on the petitioners to prove that the computer services

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[24] *Id.* at 5.

[25] *Id.*

[26] *Id.* at 6.

[27] *Id.* at 7.

were worth the entire amount avowedly paid for them.[28] On reviewing the record, the Commission found that petitioners had failed to carry this burden, and it therefore concluded that at least part of the $6000 monthly payments was in return for brokerage business.[29] The violation of section 17(e)(1) was accordingly established.

Unlike the ALJ, however, the Commission ruled that mitigating circumstances justified reducing the sanction imposed on petitioners to censure, the lightest administrative sanction available. The Commission found that petitioners' belief in the computer system was "undoubtedly sincere," and that "their belief that the law permitted them to [engage in the transactions] may well have been entertained in good faith."[30] Since this was not "a garden variety kickback case" nor a case of "a 'cunning device' fashioned for the sole purpose of advancing the interests of those who invented it,"[31] the Commission determined that its remedial purposes would be sufficiently advanced by censure.

II. Estoppel

Petitioners contend, *inter alia*, that the SEC is estopped from imposing censure because prior to these proceedings "[a]ll the relevant facts [necessary to identify a violation] were fully disclosed to the SEC."[32] They argue that in light of these disclosures the failure of Commission staff members to "suggest that there might be a violation

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[28] *Id.* at 8.

[29] *Id.*

[30] *Id.* at 10.

[31] *Id.*

[32] Brief for Petitioner Richard H. Driehaus ("Driehaus Brief") at 8. Petitioners Investors Research and Stowers join the Driehaus Brief.

of Section 17(e)" [33] should bar the Commission's present action.

The Commission is charged with protecting the public from potential abuses in the securities industry. This, of course, contemplates treating those subject to its regulation fairly.[34]

Petitioners' claim is based on a series of filings and meetings with SEC staff members which took place between November 1973 and December 1974.[35] Through

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[33] *Id.*

[34] The fundamental principle of equitable estoppel applies to government agencies, as well as private parties. *See* 2 K DAVIS, ADMINISTRATIVE LAW TREATISE §§ 17.01-17.04 (1958 & Supp. 1980); Note, *Equitable Estoppel of the Government*, 79 COLUM. L. REV. 551 (1979). *Compare* United States v. Wharton, 516 F.2d 406 (9th Cir. 1975) (government estopped from claiming ownership of land where Department of Interior advised citizen he could secure ownership through homestead); United States v. Lazy FC Ranch, 481 F.2d 985 (9th Cir. 1973) (government barred from requiring farmers to repay funds acquired from Department of Agriculture pursuant to erroneous government advice), *with* Morris v. Andrus, 593 F.2d 851 (9th Cir. 1978) (Department of Interior not estopped from cancelling illegal lease where aggrieved party previously failed to notify government of critical circumstances of the leasing arrangement); United States v. Ruby Co., 588 F.2d 697 (9th Cir. 1978) (government not estopped from resurveying lands when that option was announced at time of original survey).

[35] The first contact occurred on November 26, 1973, when the Fund filed a post-effective amendment to its own prospectus with the Commission. The amendment revealed that an unnamed brokerage firm was purchasing computer services from Investors Research. J.A. 203-04. In early 1974, Stowers received comments from Commission employees recommending some changes in the language of the amendment, but not indicating that the arrangement might violate section 17(e). J.A. 204-05. A document filed with the Commission in December of 1973 identified Mullaney, Wells as the firm pur-

these contacts, the Commission clearly learned that Mullaney, Wells was paying Investors Research $6000 per month, ostensibly for computer services. Yet at no time was it revealed that these payments were actually being made, at least in part, in return for favorable consideration in the placement of Twentieth Century's brokerage business. On the contrary, in each contact it was asserted that the $6000 payment was *for* the use of computer services, plainly implying that the services were worth $6000 and were the sole item being purchased by Mullaney, Wells.[36] In these circumstances, without benefit of the additional information it acquired through its public proceedings, the Commission had no duty to challenge the natural implication of petitioners' assertion.[37]

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chasing the computer services; the Commission made no response to the filing. J.A. 206.

Twentieth Century's 1974 prospectus, reflecting the Commission's suggestions after the 1973 post-effective amendment filing, disclosed that Mullaney, Wells was paying $6000 per month for the services to Stowers. J.A. 477-78. Later, in two more filings, the payments were again disclosed to the Commission, but still petitioners received no indication that their arrangement might violate section 17(e). J.A. 209-10.

[36] The 1974 prospectus, for example, described the computer system and then noted: "Mullaney, Wells has subscribed to the service, *for which it pays $6000 per month* to Investors Research." J.A. 478 (emphasis added).

[37] Thus, this case differs from Klein v. Securities and Exchange Commission, 224 F.2d 861 (2d Cir. 1955), the case we have found closest to the present facts. Though not phrased in terms of estoppel, the *Klein* decision barred the Commission and the National Association of Securities Dealers (NASD) from expelling a broker/dealer from the NASD because of unreasonable delay in commencing enforcement proceedings. The NASD had waited two years to commence its action after learning *all* the facts critical to establishing Klein's violation during an investigation of Klein *specifically*

III. The Allocation of the Burden of Proof

Petitioners next contend the Commission "made a mockery out of any rational concept of the . . . burden of proof" [38] by requiring them to prove that the computer services were worth the $6000 per month ostensibly paid for them. We disagree. The Commission shifted the burden only after learning the full circumstances surrounding the leasing of the computer system, and proving that Stowers had placed himself in a conflict of interest by receiving payments from the brokerage firms while serving as portfolio manager for Twentieth Century.[39] As such, the Commission applied the long-standing principle that once a conflict of interest is proven, the burden shifts to the party in conflict to prove that he has been faithful to his trust.[40] In the context of section 17(e)(1), the specific burden is for the affiliated person to prove that he has received no compensation "for the purchase or sale of any property to or for" the investment company. The Commission correctly found that petitioners were unable to do this.[41]

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focused on possible violations of the law he was expelled for breaking. Here, in contrast, there is no evidence the Commission learned all the facts of the violation until its public proceedings; and, to the extent the Commission was previously apprised of some of the circumstances of the computer leasing arrangement, it acquired this information through general filings or routine examinations, rather than a focused inquiry under section 17(e)(1). *See* 15 U.S.C. § 78z (1976) (failure of Commission to act in response to statements in prospectus not prejudicial to later action).

[38] Driehaus Brief at 49.

[39] SEC Opinion at 2-3, 7-8.

[40] Sheridan v. Perpetual Building Association, 299 F.2d 463, 465 (D.C.Cir. 1962).

[41] We also reject petitioners' assertion that the Commission improperly applied a "preponderance of the evidence" standard of proof to this action, rather than the higher "clear and convincing" standard. The higher standard is not mandated by Collins Securities Corp. v. SEC, 562 F.2d 820

IV. The Meaning of "Acting as an Agent"

Section 17(e)(1)'s prohibition extends to affiliated persons of a registered mutual fund if they are "acting as an agent."[42] The statute does not specify for whom the affiliated person must be "acting as an agent," and petitioners rely on this ambiguity to claim that the statute prohibits the receipt of compensation only when the affiliated person acts pursuant *to a formal agency relationship with a third party* dealing with the mutual fund. Petitioners reason that since no formal agency relationship existed between Stowers and Mullaney, Wells, no violation of the Act can be found.

While the language "acting as an agent" is facially susceptible to petitioners' reading, it cannot be read in a vacuum. The Investment Company Act in general, and section 17(e)(1) in particular were designed to prohibit the many varieties of conflicts of interest which have historically plagued the investment company industry.[43] The statute seeks to insure the "independence of

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(D.C.Cir. 1977), the case petitioners rely on. *Collins* required the higher standard in *fraud* actions where a *severe sanction* is imposed. Since neither one of these elements is found in this case, *Collins* is inapplicable.

[42] *See* note 1 *supra*. None of the parties challenge that Stowers and Investors Research are "affiliated persons" of Twentieth Century. The textual references to "Stowers" in this section, accordingly, apply as well to Investors Research.

[43] For a summary of the scandalous conditions which led to the enactment of the Investment Company Act, *see* Note, *The Investment Company Act of 1940*, 50 Yale L. J. 440 (1940). For indications that these abuses still exist on a large scale today, *see* Project, *The Mutual Fund Industry: A Legal Survey*, 44 Notre Dame Law. 732, 812 (1969); Note, *Conflicts of Interest in the Allocation of Mutual Fund Brokerage Business*, 80 Yale L.J. 372 (1970). The legislative history of the Act is ably recounted in United States v. Deutsch, 451 F.2d 98 (2d Cir. 1971) *("Deutsch")*.

management and its fidelity to shareholders" [44] by setting forth broad standards prohibiting the wide variety of conflicts which may compromise an affiliated person's judgment. Accepting petitioners' contention would defeat this important congressional purpose.

Nothing in the legislative history of section 17(e)(1) indicates that a formal agency relationship with a third party is required for liability.[45] On the contrary, the statutory language was apparently chosen to prohibit affiliated persons from accepting compensation when they act as agent for either a third party or the mutual fund itself,[46] an interpretation the Commission has accepted

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[44] *Deutsch, supra*, 451 F.2d at 108.

[45] Petitioners point to only one statement in the entire legislative history of the Investment Company Act in support of their restrictive interpretation. In this brief passage, Mr. David Schenker, Chief Counsel of the SEC Investment Trust Study and a principal draftsman of the Act, noted the problem posed by an affiliated person who acts as real estate agent for an outsider selling property to a fund, and commented that section 17(e)(1) was designed to remedy this situation. He emphasized, however, that the problem with this arrangement was the conflict of interest in which the affiliated person found himself; Schenker did not emphasize the technicalities of agency relationships *per se*. Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. (1940) (hereinafter "Senate Hearings") at 262. It is our view, therefore, that this lone passage does not indicate that the phrase "acting as an agent" was meant to refer only to formal agency relationships with outside parties. Rather, the passage indicates that section 17(e)(1) is designed to prevent conflicts of interest. The agency requirement is designed to limit the class of affiliated persons subject to the statutory prohibiiton.

[46] Had Congress wished to limit section 17(e)(1) as petitioners suggest, it could easily have done so by specifying for whom the affiliated person must be acting as an agent. In the absence of any such limiting language, or evidence of the intent ascribed to Congress by petitioners, we cannot

for many years.[47]

Whether Stowers was acting as an agent for Twentieth Century, as the Commission found, must be viewed in light of his position within the Fund's management structure in order to properly assess the potential harm to shareholder interests should compensation continue. We agree with the Commission the present record demonstrates that Stowers' position in the Fund and concurrent receipt of compensation did pose a substantial danger to shareholders. As the Commission noted:

> No longer could [Stowers] look at Twentieth Century's brokerage problems with an eye single to Twentieth Century's interests. Now he had an interest of his own at stake. He could not compare the brokerage services that Mullaney offered with those offered by other firms in the wholly disinterested way that the statute contemplates. * * * Stowers' fiduciary duty to Twentieth Century required him to do all that he reasonably could to keep transaction costs down. His self-interest in keeping Mullaney satisfied . . . pointed the other way. This made it somewhat less likely that he would drive hard bargains with Mullaney. It also gave him an incentive to churn Twentieth Century's portfolio.[48]

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interpret the statute in the constrictive fashion which petitioners suggest. *See Deutsch, supra,* 451 F.2d at 111-12.

[47] *See* Arthur Lipper Corp., Securities and Exchange Act Release No. 11773 (Oct. 24, 1975), 8 SEC Docket 273, *modified,* 547 F.2d 171 (2d Cir. 1976); Winfield & Co., Securities and Exchange Act Release No. 9478 (Feb. 9, 1972); Provident Management Corp., Securities and Exchange Act Release No. 9028 (Dec. 1, 1970); Consumer Investor Planning Corp., Securities and Exchange Act Release No. 8542 (Feb. 20, 1969). Of course, we give great weight to these administrative interpretations. E.I. duPont de Nemours & Co. v. Collins, 432 U.S. 46, 54-55 (1977).

[48] SEC Opinion at 7.

V. SCIENTER

Finally, petitioners contend the Commission improperly neglected to consider the question of scienter. Investors Research and Stowers, who were sanctioned as principals for violating section 17(e)(1), argue that the Supreme Court's decision in *Ernst & Ernst* v. *Hochfelder* [49] mandates a scienter requirement for liability under the statute. Petitioner Driehaus, who was sanctioned for aiding and abetting the primary violations, argues further that principles intrinsic to the law of accessorial liability require that he, at least, be found to possess some degree of scienter.[50]

As to the principal violators, we find that the *Hochfelder* decision does not mandate a scienter requirement for section 17(e)(1) liability. *Hochfelder* merely held that scienter was an element in a private action for damages under section 10(b) of the Securities and Exchange Act of 1934.[51] The decision was based on the particular statutory language at hand, which, in the Court's words, "clearly connotes intentional misconduct." [52] The same cannot be said of section 17(e)(1). It sets forth a flat ban on certain conduct tending to compromise the fiduciary judgment of affiliated persons. There is no language suggesting a scienter requirement. Indeed, the legislative history of section 17 demonstrates very specifically that Congress did not intend to saddle the Commission with the difficult problem of proving fraudulent or "larcenous intent." [53]

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[49] 425 U.S. 185 (1976).

[50] Driehaus Brief at 52-53.

[51] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976).

[52] *Id.*

[53] Senate Hearings, *supra* note 47, at 131.

Petitioner Driehaus' liability, however, does not directly flow from the statute. Section 17(e)(1), by its terms, prohibits only the *receipt* of certain compensation by affiliated persons. The Commission does not contend that Driehaus received any monies at all, nor that he is an affiliated person of Twentieth Century. Instead, the Commission held that, by assisting Stowers in selling the computer system to Mullaney, Wells and Olde & Co., Driehaus *aided and abetted* the primary violations by Stowers and Investors Research.[54]

We are aware of no authority addressing the question of whether some level of scienter is required for liability as an aider and abettor under section 17(e)(1).[55] Courts have frequently considered scienter requirements for aiders and abettors under anti-fraud statutes, however.[56] We believe the principles developed in these cases apply with equal, if not greater, force in the context of a conflict of interest statute like section 17(e)(1). The scienter requirement for aiding and abetting liability is designed to insure that innocent, incidental participants

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[54] Driehaus was prosecuted pursuant to 15 U.S.C. § 80a-9(b)(e) (1964), which provides for administrative sanctions against any person who "has willfully aided, abetted, counseled, commanded, induced, or procured" a violation of the Act by any other person.

[55] In *Deutsch*, *supra*, the Second Circuit upheld an aiding and abetting violation of section 17(e)(1), but only in the limited circumstances where the alleged aider and abettor was the payor of the compensation in question. The court's discussion of whether specific intent to influence was required under the statute, therefore, cannot be regarded as a consideration of the scienter requirement for section 17(e)(1) aiders and abettors in general.

[56] *See, e.g.*, Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975); Securities and Exchange Commission v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 422 U.S. 1004 (1975); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

in transactions later found to be illegal are not subjected to harsh, civil, criminal, or administrative penalties.[57] This policy is especially germane where the proscribed conduct of the principal may not always appear to be wrongful, as may often be the case under section 17(e)(1).

To the extent the Commission concedes a need for any scienter requirement at all, it argues that a negligence standard meets the concerns mentioned above. The Commission contends that an accused aider and abettor can be censured whenever he "should have been able to conclude that his act was likely to be used in furtherance of illegal conduct." [58] We do not agree. This standard has previously been used only in civil injunctive actions [59] where the paramount concern is terminating the illegal conduct, not sanctioning wrongdoers. It creates a duty to investigate potential violations of law which "in essence would amount to eliminating scienter as a necessary element in imposing aiding and abetting liability." [60] Where sanctions can be imposed, the negligence standard provides insufficient protection for those persons whose

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[57] *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution,* 120 U. PENN. L. REV. 597 (1972) (hereinafter "Ruder").

[58] Brief for SEC, Respondents, at 42, *quoting* Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801, 811 (2d Cir. 1975).

[59] Securities and Exchange Commission v. Coven, 581 F.2d 1020 (2d Cir. 1978); Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975). *See also* Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192-93 (1963) (distinguishing between criminal punishment, administrative sanctions, and injunctive relief).

[60] Ruder, *supra* note 59, at 120 U. PENN. L. REV. 633.

involvement in securities law violations is in one respect substantial, yet wholly innocent.[61]

In *Woodward v. Metro Bank of Dallas*, [62] the Fifth Circuit fashioned a test for aider and abetter liability which we believe strikes the correct balance between the public interest in enforcing the securities laws and the danger of unduly burdening the securities industry. The court held that to establish liability, three elements must be proven: 1) another party has committed a securities law violation; 2) the accused aider and abetter had a general awareness that his role was part of an overall activity that was improper; and 3) the accused aider and abetter knowingly and substantially assisted the principal violation.[63]

In assessing petitioner Driehaus' liability, the Commission expressly disavowed the need to find scienter.[64] Thus, contrary to part two of the *Woodward* test, the Commission failed to consider whether Dreihaus had a general awareness that he was assisting Stowers in wrongful conduct, *i.e.*, securing payments from the

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[61] Dean Ruder has pointed out that in most cases, an alleged aider and abettor "will merely be engaging in customary business activities, such as loaning money, managing a corporation, preparing financial statements, distributing press releases, completing brokerage transactions, or giving legal advice." Ruder, *supra* note 59, at 120 U. PENN. L. REV. 632. In a particular case, any of these activities could constitute substantial assistance to the principal wrongdoer, yet any can be performed in complete good faith by an actor totally unaware that anything improper is occurring. Where the activities of the alleged aider and abettor are in this respect innocent, it would be unjust to utilize secondary liability principles to impose punishment or administrative sanctions as the Commission proposes.

[62] 522 F.2d 84 (5th Cir. 1975).

[63] 522 F.2d at 94-97.

[64] SEC Opinion at 4-5 n.15.

brokerage firms made, at least in part, for favorable consideration in the selection of Twentieth Century's brokers. This omission has led to a record which contains contradictory indications as to whether Driehaus possessed the needed state of mind.[65] We cannot uphold the Commission's censure of Dreihaus amidst these inconsistencies, and therefore we vacate the Commission's order in No. 78-1597 and remand so the Commission may reexamine the evidentiary record, and if necessary gather further evidence required for a proper resolution of this issue.

VI. Conclusion

In summary, we hold that the Commission is not estopped from prosecuting this action, that it properly allocated the burden of proof in its proceedings below, and that Stowers and Investors Research were each "acting as an agent" when they received compensation forbidden by section 17(e)(1). Further, we hold that scienter is not an element of a principal violation of section 17(e)(1). We therefore affirm the Commission's order of censure against Stowers and Investors Research (No. 78-1589).

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[65] In its brief, for example, the Commission alleges that "Driehaus was involved in every aspect of the relevant transactions." Brief for SEC, Respondents, at 43. They point to evidence in the record establishing his close relationship with Stowers, his assistance in persuading Mullaney, Wells to purchase access to the computer system, and his knowledge that Becker & Co. lost the Twentieth Century account after refusing to purchase computer services. *Id.* On the other hand, the Commission stated in its opinion that petitioners' "belief that the law permitted them to [engage in these transactions] may well have been entertained in good faith." SEC Opinion at 10. These factors conflict, and thus it is unclear from the record before us and the Commission's findings whether Driehaus indeed "had a general awareness that his role was part of an overall activity that was improper."

As to petitioner Driehaus, we hold that the Commission was required to make findings on the question of scienter for aiders and abettors. We therefore vacate the Commission's order in No. 78-1597 and remand for such further proceedings as may be necessary to adequately address the issue of scienter as set forth herein.[66]

So ordered.

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[66] Petitioners' remaining contentions have been considered and found to be without merit.

APPENDIX B

UNITED STATES COURT OF APPEALS
For the District of Columbia Circuit

September Term, 1979

No. 78-1589

Investors Research Corporation

and

James E. Stowers,
Petitioners,

v.

Securities and Exchange Commission,
Respondent.

And Consolidated Case No. 78-1597

BEFORE: Wright, Chief Judge; Bazelon, Senior Circuit Judge; and Tamm, Circuit Judge

ORDER

(Filed June 11, 1980)

It appearing that respondent Securities and Exchange Commission has filed a motion seeking clarification of the use of the word "scienter" in the Opinion for the Court filed herein on April 29, 1980, because "scienter" has acquired a technical definition for certain limited purposes, *see Ernst & Ernst v. Hockfelder*, 425 U.S. 190, 193, n.12 (1976), in addition to its more familiar general meaning, SEE H. BLACK, BLACK'S LAW DICTIONARY, 1207 (5th ed. 1979); and no opposition thereto having been filed, it is

ORDERED, by the Court, that respondent's aforesaid motion for clarification is hereby granted and the Opinion entered herein on April 29, 1980, is amended as follows:

On page 17, strike the heading "SCIENTER" following "V." on the first line, and insert in lieu thereof "STATE OF MIND";

On page 17, line two of text, strike the word "scienter" and insert in lieu thereof "their state of mind concerning the wrongfulness of the computer leasing arrangement";

On page 17, line 11 of text, strike the words "degree of scienter" and insert in lieu thereof "awareness that the leasing arrangement was suspect";

On page 18, line two of the second paragraph, strike the words "whether some level of scienter" and insert in lieu thereof "what state of mind";

On page 18, line four of the second paragraph, strike the word "scienter" and insert in lieu thereof the word "such";

On page 18, line 9 of the second paragraph, strike the word "scienter" and insert in lieu thereof "awareness of wrong-doing";

On page 18, line 7 of n.55, strike the word "scienter" and insert in lieu thereof "state of mind";

On page 19, line two of the first full paragraph, strike the word "scienter" and insert in lieu thereof "state of mind";

On page 19, line 12 of the first full paragraph, strike the word "scienter" and insert in lieu thereof "[any awareness of wrong-doing]";

On page 20, line two of the second full paragraph, strike the words "find scienter" and insert in lieu thereof "make any findings regarding petitioners' knowledge of wrong-doing";

On page 20, n.64, strike the period at the end of the footnote and insert "& n.16.";

On page 22, line two, strike the word "scienter" and insert in lieu thereof "the requisite state of mind";

On page 22, line six of text, strike the word "scienter" and insert in lieu thereof "state of mind".

Per Curiam
FOR THE COURT:
/s/ George A. Fisher
George A. Fisher
Clerk

APPENDIX C

[¶ 81,586] In the Matter of Investors Research Corporation.

Securities and Exchange Commission. Administrative Proceeding File No. 3-4669. May 1, 1978. Opinion of the Commission in full text.

Investment Companies—Conflict of Interest—Research Services—Computer Leasing Arrangement.—A situation where an investment adviser and its president would direct an affiliated investment company's business to a brokerage firm at the same time that the brokerage firm shared the costs of the investment adviser's computer leasing service is a violation of Section 17(e)(1) of the Investment Company Act. The benefits of this reciprocal arrangement were divorced from the burdens. The payments that the brokerage firm made went to the adviser, whereas the commissions paid to the brokerage firm were borne by the investment company's shareholders. The policy of Section 17(e)(1) is to prevent affiliated persons from having their judgment and fidelity impaired by conflicts of interest, such as exist here.

See ¶ 48,402, "Investment Companies—Affiliates; Functions; Directors" division, Volume 4.

Investment Companies—Violation of Section 17(e)(1)—Sanction.—Since the arrangement described above was not a "garden variety kickback case", and the respondents sincerely believed in the legality and necessity of their arrangement, the Commission reduced the administrative law judge's revocation of registration sanction to a censure.

See ¶ 48,402, "Investment Companies—Affiliates; Functions; Directors" division, Volume 4.

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Irving Kuraner, of Kuraner, Dingman, Brockus, Kinton & Lowe, for Investors Research Corporation and James E. Stowers.

Milton S. Gould and Geoffry R. Handler, of Shea, Gould, Climenko & Casey, for Richard H. Driehaus.

Paul B. O'Kelly and Max M. Luck, for the Commission's Division of Enforcement.

INVESTMENT ADVISER, INVESTMENT COMPANY, AND BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Proscribed Compensation

Investment company's registered investment adviser that received compensation proscribed by Section 17(e)(1) of the Investment Company Act from broker who executed investment company's portfolio transactions, *censured*, together with adviser's controlling person and brokerage firm's research director who participated in the arrangement that resulted in the brokerage firm's payments to the adviser.

I.

James E. Stowers is president of both Twentieth Century Investors, Inc. ("Twentieth Century"), a registered investment company,[1] and Investors Research Corporation ("Research"), the registered investment adviser that manages Twentieth Century.[2] Stowers, Research, and Richard H. Driehaus, a broker to whom Stowers has given much of the brokerage business that Twentieth Century gen-

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1. During the relevant period, Twentieth Century's net assets ranged from $8.6 million to $13.2 million.

2. Stowers owns 66% of Research's common stock.

erates, appeal from an administrative law judge's decision adverse to all three.

Stowers was Research's portfolio manager. Hence he made all of Twentieth Century's investment decisions. By 1972, Stowers had developed great confidence in Driehaus's investment advice and market judgment. So Stowers placed most of Twentieth Century's portfolio brokerage with the firm with which Driehaus was then associated, B Company.

In collaboration with Driehaus, Stowers developed a methodology for spotting undervalued stocks. But the application of that methodology to the formulation of concrete investment decisions was slow and laborious. To overcome these difficulties and exploit his method more effectively, Stowers leased a computer and developed a program for it.[3] The computerized system that Stowers developed covered a very large number of publicly held companies.

Stowers professed great faith in his system's merit. But he found its cost beyond his means.[4] Hence he looked around for someone "to pick up the cost of [leasing] the computer" in return for access to the material it produced. He offered Driehaus's then firm, B Company, access to the

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3. The computerized system consists of display stations, and of equipment which provides daily, weekly and monthly print-outs. The display station shows on a screen "earnings and revenue data and analyses of any one of the . . . companies in the data bank." The print-outs, which according to respondents represent "the most important feature of the system," identify the stocks in the data bank "whose revenues and earnings show promise, classifying them in various ways."

4. At oral argument, Stowers's counsel said, "Mr. Stowers knew at the outset that, while he could do the development work and operate the computer, someone else . . . would have to pick up the cost of the hardware."

system for $15,000 down plus $6,000 a month.[5] But B Company turned him down.[6] He then made the same proposal to another securities firm. It too was unwilling to accept it.[7]

Stowers thereupon made the same offer to a third securities firm, Mullaney, Wells & Company. It accepted. In August 1973, Mullaney agreed to pay Research $15,000 down and $6,000 a month for the use of the system.[8] Driehaus then joined Mullaney as its research director.[9] And virtually all of Twentieth Century's portfolio business went to him at that firm.[10] This made Twentieth Century Mullaney's largest and most important customer.

Most of Twentieth Century's portfolio transactions were effected on an agency basis. Between August 1973 and December 1974, Mullaney collected $422,464 in com-

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5. Research had already spent some $15,000 in computer rental fees. And those fees were continuing. At that time they ran about $6,000 a month. In addition, Research incurred other expenses in connection with the operation of the system.

6. Stowers admitted that B Company did not think the system would be of any value to it.

7. Stowers testified that this firm balked at the $15,000 down payment.

8. The agreement permitted Mullaney to sell print-outs from the system, and to sell display station installations for fees to be negotiated between Research and Mullaney.

9. Driehaus asserts that he considered Mullaney's leasing of the system "an expression of faith in his investment philosophy and [that] this was an important factor in his decision to join Mullaney." By the spring of 1974, he had acquired a 12%-15% equity interest in Mullaney.

10. In August of 1974, Mullaney went out of business and another securities firm, Olde and Company, Inc. acquired Mullaney's accounts. When that happened, Driehaus joined Olde as its research director. Olde continued to make the $6,000 monthly payments to Research. And Research gave virtually all of Twentieth Century's portfolio business to Olde. For purposes of this opinion, the term "Mullaney" includes "Olde," unless the context shows otherwise.

missions on those transactions.[11] At the same time, Mullaney made substantial payments to Research purportedly for the use of the computer system. In the period August 1973-September 1975, those payments amounted in the aggregate to some $171,000.

II.

The issues before us are narrow and precise. They are:

(1) Research was selling Stowers's system to Mullaney at the very same time that Research was directing virtually all of Twentieth Century's portfolio brokerage to that firm. Did this enmesh Research and Stowers in a conflict of interest prohibited by the Investment Company Act?

(2) If that question is answered in the affirmative, what remedial action, if any, should we take?[12]

III.

The administrative law judge's answer to the first question was adverse to the respondents. So is ours. With respect to the remedy, however, our views are far different from his.

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11. Mullaney and Olde were also named respondents in these proceedings. The Administrative law judge revoked Mullaney's broker-dealer registration. Mullaney did not appeal that sanction. Nor did the Commission choose to review it on its own motion. Hence it has become final. Securities Exchange Act Release No. 12807 (September 16, 1976), 10 SEC Docket 470.

With its consent, Olde was suspended from engaging in market-making activities for two weeks. Olde also undertook to pay Twentieth Century $29,000 and to terminate its computer leasing arrangements with Research. Securities Exchange Act Release No. 11952 (December 24, 1975), 8 SEC Docket 895.

12. The administrative law judge found certain other violations. But we do not think that the record warrants adverse findings on those matters.

The law judge found "no genuinely mitigating circumstances." Hence he concluded that:

(1) Research's registration as an investment adviser should be revoked; and

(2) Both Stowers and Driehaus should be barred from association with brokers, dealers, and investment advisers, and prohibited from serving or acting in various capacities with respect to registered investment companies.

We, on the other hand, see significant mitigating factors. In our view this is a most unusual situation. And we have not been persuaded that it calls for anything more drastic than censure.

Our reasons for so holding are stated below.

IV.

We agree with our staff and with the administrative law judge that Section 17 (e) (1) of the Investment Company Act[13] prohibits payments of the kind that Mullaney made to Research. Hence we find that:

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13. The section reads: "It shall be unlawful for any affiliated person of a registered investment company . . . acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker."

(A) Research and Stowers[14] willfully violated that section,[15] and (B) Driehaus willfully aided and abetted his co-respondents' willful violations.[16]

Respondent's argument to the contrary revolves around the premise that their was a bona fide business relationship that the Act does not ban. As they see it, the heart of the matter is that Stowers's system was effective but expensive.

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14. Since Research was Twentieth Century's investment adviser, it was an "affiliated person" of Twentieth Century. See Section 2(a)(3)(E) of the Investment Company Act. Stowers was also an affiliated person of Twentieth Century because he was an officer and an employee of that company. See Section 2(a)(3)(D) of the Investment Company Act.

15. Research and Stowers insist that they did not know that Section 17(e)(1) prohibited what they were doing. But willfulness "does not require proof of . . . intent to violate the law, or knowledge that the law was being violated." 5 Loss, Securities Regulation 3368 (1969 supp.). The word "willfully" in the securities statutes merely refers to the actor's will to commit the act that constitutes the violation. See, e.g., *Tager v. S. E. C.*, 344 F. 2d 5, 8 (1965), affirming our decision in *Sidney Tager*, 42 S. E. C. 132 (1964). This case meets that test. All of the transactions were carefully fashioned. There was nothing inadvertent or accidental. Indeed, no one contends that there was.

Respondents' contention that *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976) changed the law in this area so as to require a showing of specific intent to violate the Investment Company Act is frivolous. See *Arthur Lipper Corporation v. S. E. C.*, 547 F. 2d 171, 180 (C. A. 1976), *cert. denied*, ... U. S. ..... (1978), where the court quoted *Tager* with approval and reaffirmed it in a post-*Hochfelder* setting. Moreover, *Hochfelder* involved an action under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. Assuming that the case is applicable to administrative proceedings of this sort, a position with which we disagree, we fail to see what bearing it has on Section 17(e)(1) of the Investment Company Act.

Equally irrelevant to the willfulness issue is the fact that the computer arrangement was disclosed in Twentieth Century's prospectuses. Section 17(e)(1) lays down a flat prohibition. Like the Investment Company Act's other regulatory provisions, it reflects a legislative determination that disclosure itself is an inadequate safeguard in the investment company field. See Senate Report No. 1775, 76th Cong. 3d Sess. (1940) at page 6.

16. *United States v. Deutsch*, 451 F. 2d 98 (C. A. 2, 1971), *cert. denied*, 404 U. S. 1019 (1972), (hereinafter cited as "*DEUTSCH*") sustained a criminal conviction for aiding and abetting a violation of the section of the Investment Company Act that is involved here.

Economic exigencies required that the cost of the system be shared.

So Research and Mullaney entered into an expense-sharing arrangement. This gave Mullaney access to a research tool that is said to have been of great aid to it. It facilitated the management of Twentieth Century's portfolio because it supplied Driehaus with the information on which Stowers relied, thus enabling the two of them to work together more efficiently than would otherwise have been possible. Mullaney also used the system to service other clients.

Had this been a simple, two-sided relationship between an investment company and its broker in which Twentieth Century bought brokerage services from Mullaney and also sold research aids to that firm, we would see nothing wrong with the arrangement under Section 17(a)(1). That section does not inhibit the investment company's freedom of action. Hence Twentieth Century would be free to supplement *its* income by selling Stowers's system to anyone who wanted to buy it.

But that is not this case. This was not a simple two-sided relationship of the kind that we have just posited. It was a complex three-sided one.

Twentieth Century, the investment company, was buying brokerage services from Mullaney. In return for those services, Twentieth Century was paying large sums to Mullaney. The burden of those payments was borne by Twentieth Century's shareholders.

But Twentieth Century did not own Stowers's computerized system. Twentieth Century's investment adviser, Research, owned it. Hence the revenues produced by selling the system went to Research.[17]

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17. Stowers in turn used the funds to operate the system.

Thus the benefits of the reciprocal relationship between Research and Mullaney were separated from the burdens. The benefits, the payments that Mullaney made for the computer, went to the adviser. The burdens, i.e., the commissions and the spreads that Mullaney collected, were borne by the investment company's shareholders.

This divorce of benefit from burden created a situation squarely covered by Section 17(e)(1)'s words and by the basic policy that the authors of those words sought to implement. That policy was, as the Court of Appeals for the Second Circuit has said "to prevent affiliated persons from having their judgment and fidelity impaired by conflicts of interest."[18] No showing of actual impairment need be made. This is a prophylactic statute. Its aim is not to redress harm but to prevent it.[19] Hence all that need be established is a relationship that "*could* . . . becloud [the fiduciaries'] judgment to the detriment of the beneficiaries of the [fund]." (Emphasis added.)[20]

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18. *DEUTSCH* at 109.

19. It follows that respondents' vehement protestations that the investment company was unharmed and that it actually reaped great benefits from the computer have no bearing on the question of whether Section 17(e)(1) was violated. Harm or its lack goes only to the question of sanction. And on that we have given considerable weight to the circumstances that respondents stress.

20. *DEUTSCH* at 109.

DEUTSCH was a criminal case. Nevertheless, the court read 17(e)(1) broadly so as to effectuate its legislative purpose. It noted that "The Act was . . . designed . . . quite clearly to establish broad standards which would more easily enable the government to convict affiliated persons for self-dealing in the management of investment companies—an industry the very nature of which made it particularly difficult to gather "proof" (451 F. 2d at 108), and that, "[g]iven the nature of the investment company industry, it would be extremely difficult to prove that the payment of compensation actually caused a particular purchase" (451 F. 2d at 109). Unlike *DEUTSCH*, the instant proceedings are remedial, not penal. Hence it would be inappropriate for us to read the statute more permissively here than the *DEUTSCH* court did in a criminal context.

The computer leasing deal had that potential beclouding effect. True, Stowers gave Driehaus Twentieth Century's business in the pre-computer period as well as in the post-computer one. But, in the earlier period, he had no private pecuniary motive for doing so. During the later period, however, he could scarcely have been oblivious to the $6,000 a month that his company, Research, was getting from Mullaney. He admits that this money was very important to Research. Thus he was under a self-created pressure to send Mullaney enough Twentieth Century brokerage to enable Mullaney to keep making payments to Research.

No longer could he look at Twentieth Century's brokerage problems with an eye single to Twentieth Century's interests. Now he had an interest of his own at stake. He could not compare the brokerage services that Mullaney offered with those offered by other firms in the wholly disinterested way that the statute contemplates.

Even if one looks only at Mullaney and ignores for the moment the existence of other brokerage firms that were eager for business, one sees that the computer arrangement injected a patently improper term into the equation.

Stowers's fiduciary duty to Twentieth Century required him to do all that he reasonably could to keep transaction costs down. His self-interest in keeping Mullaney satisfied and in seeing to it that it received enough business and enough money from Twentieth Century to cover its computer rentals pointed the other way. This made it somewhat less likely that he would drive hard bargains with Mullaney. It also gave him an incentive to churn Twentieth Century's portfolio.[21]

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21. Twentieth Century's May 1, 1975 prospectus states that the fund's portfolio turnover rate "may be greater" than that of most other investment companies.

Respondents maintain that Stowers rose above these temptations. Perhaps he did. But his legal duty was not discharged by resisting such self-created lures. The Act required him to avoid them.[22]

V.

Respondents place great stress on the efficacy of Stowers's computerized system. They consider it a valuable research tool. And they emphasize the heavy cost of operating it and keeping it up to date. Hence they argue that:

(1) The system was worth more to Mullaney than it paid. Indeed, Stowers and Research gave Mullaney a real bargain.

(2) This means that *all* of the money that went from Mullaney to Research must be deemed to have been paid for access to the computer.

(3) So Mullaney never paid Research or Stowers for Twentieth Century's brokerage. Neither Research nor Stowers enriched themselves out of that brokerage. There was no kickback.

(4) Accordingly, there was no "compensation . . . for the purchase or sale of any property to or for [the] registered company," i.e., Twentieth Century.

(5) Since there was no "compensation" of that type, there was no violation of Section 17(e)(1).

We have two difficulties with this analysis. The first stems from the character of the relationship between the parties. This was a regular course of business in which:

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22. As noted earlier, and as *DEUTSCH* makes clear. Section 17(e)(1) prohibits conflicts of interest whether or not actual harm can be proven. See the Supreme Court's discussion of the evil that can flow from an adviser's "subconscious" prejudices in favor of his own financial interests. *S. E. C. v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 188 (1963).

(1) Large amounts of money were continually moving from the investment company to the broker that its adviser had selected:

(2) Other subtsantial sums were moving from that broker to the adviser;[23] and

(3) The two streams were flowing copiously and simultaneously.

Triangles like that are ideal channels for the rebates and kickbacks that Section 17(e)(1) prohibits. Hence they are presumptively suspect. People who become parties to such arrangements must be prepared to show affirmatively that none of the money paid to the adviser was "for" the brokerage at his disposal.[24] It must be shown that what was received had a fair market value sufficient to warrant the conclusion that all of the money alegedly paid for it was actually disbursed for that purpose.[25] Absent that, at least some portion of the broker's disbursements must be deemed to have been paid and received as compensation for the business forwarded by the adviser.

That brings us to our second basic difficulty, which is that there was no market—and therefore no market price—for Stowers's novel, untried, and expensive system. Hence there was no objective standard by which to measure

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23. The broker not only knew that he owed the business to the adviser but that the adviser had the power to take it away from him.

24. We find nothing to the contrary in *Steadman Security Corporation*, Securities Exchange Act Release No. 13695 (June 29, 1977), 12 SEC Docket 1041 (hereinafter cited as "*STEADMAN*"). Save for an isolated transaction involving a certificate of deposit as to which the record was unclear, that case did not involve "compensation . . . for the purchase or sale of any [investment company] property." See 12 SEC Docket at 1054.

25. Respondents point to the testimony of an IBM marketing representative placing the computer program's reproduction cost at between $160,000 and $300,000. But that, of course, has nothing to do with "market value." The "market value" of which we speak is the price that an arms-length buyer uninfluenced by the receipt of brokerage would be willing to pay for access to Stower's system.

the reasonableness of the price that he was charging for it. Without such a measuring rod, there is no adequate predicate for respondents' conclusion that Mullaney's payments to Research were unrelated to Mullaney's income from Twentieth Century.

Stowers's faith in his own system is no substitute for the impersonal judgment of the marketplace. We are told that Stowers convinced Driehaus of the system's merit. But Driehaus's relationship with Stowers was extremely remunerative for Driehaus. To keep that relationship fully intact, he had to associate himself with a firm that was ready to spend a lot of money on Stowers's system.[26]

Of course, that money was Mullaney's money. But it came from Twentieth Century's commissions. Appreciable portions of those commissions found only a momentary resting place in Mullaney's coffers.

We think it clear that the nexus between Mullaney's payments to Research and Research's direction of Twentieth Century's portfolio brokerage to Mullaney was so close as to compel the inference that the payments were made for a single package in which access to Stowers's computer was inextricably intertwined with access to Twentieth Century's portfolio brokerage.[27]

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26. We note Stowers's testimony that Driehaus would have gotten only "some" of Twentieth Century's business if he did not have the computer and stock to "his old way." After Mullaney agreed to pay for the use of Stowers's system, Driehaus joined the firm. And he got not just *"some"* but practically *all* of Twentieth Century's business.

27. This means, of course, that at least some, if not all, of the money that Mullaney paid out was for the brokerage.

We note in this connection that, before Mullaney went out of business in August 1974, it was in financial difficulties. The administrative law judge observed that, in late 1973, its financial condition became precarious. Subsequently, Mullaney's "net capital position declined to a 15 to 1 ratio and it was forced to institute a number of cost-cutting procedures. *However, it continued to use the computer system and to pay the* $6,000 *a month.*" (Emphasis added).

The record does not show that anyone not interested in getting brokerage was willing to pay anything like $6,000 a month for Stowers's system. And only evidence of that type could rebut the inferences flowing from the symbiotic relationship between Twentieth Century's payments to Mullaney and Mullaney's payments to Research.[28]

It follows that the compensation derived by Research and Stowers from leasing the computer system to Mullaney was banned by Section 17(e)(1).

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28. Even that kind of evidence might not be enough to rebut those inferences in view of Mullaney's financial plight (see n. 27, *supra*), and the importance to it of the business that Stowers was sending to Driehaus. Suppose that Stowers had succeeded in convincing some banks, some other investment advisory organizations, and some brokers who got no brokerage business from him that his system was indeed worth $6,000 a month. That would establish "market value" to a certain kind of buyer. This would shift the burden of going forward to our staff.

But it would not necessarily end the inquiry. Evidence that the system could not reasonably be deemed to have been worth anything like $6,000 a month to *Mullaney* were it not for the brokerage business that it was getting from Stowers would still raise a Section 17(e)(1) question. That such a firm was buying an extremely expensive research aid from the investment company manager who was sending it a very large volume of brokerage business could reasonably be viewed as both a purchase of the investment company manager's good will and a purchase of the service that he was selling. In these circumstances it is by no means clear that the element of "compensation" to the manager for the investment company's brokerage would be lacking. It must be remembered that Section 17(e)(1) does not speak of "gifts," "bribes," "gratuities," or "kickbacks." Its scope extends far beyond that. Section 17(e)(1) reaches almost every situation in which a member of the class of persons referred to therein receives "any compensation (other than a regular salary or wages . . .) for the purchase or sale of any property to or for [the] registered [investment] company" with which he is affiliated. The term "compensation" is a synonym for economic benfit. See *STEADMAN* at 1052 of 12 SEC Docket, n. 38. And sales even at fair market value are of economic benefit to the seller. Hence, unless one of the stated exemptions is applicable, even a sale at fair market value falls under Section 17(e)(1)'s ban whenever there is a quid pro quo for a transaction involving the investment company's property. See 12 SEC Docket at 1054.

VI.

We now turn to the question of what remedial action is appropriate in the public interest.

This is not a garden variety kickback case in which an investment company's manager and its portfolio broker concoct some fraudulent scheme for the sole purpose of lining their own pockets at the shareholders' expense. Respondents' belief that Twentieth Century actually has benefited from Stowers's system is undoubtedly sincere. And the record lends support to their view. Unfortunately, the method by which the system was financed showed a deplorable lack of fiduciary sensitivity.

We do not condone what was done. But realism constrains us to recognize that the respondents were confronted by a difficult problem and that their belief that the law permitted them to resolve it as they did may well have been entertained in good faith. The views expressed in this opinion are not novel. They are in accord with those that the staff of our Division of Investment Management has taken for many years. However, this is the first time that the Commission itself has dealt with the Investment Company Act's impact on a business relationship of the type involved here.

Our past pronouncements gave no specific guidance in this concrete situation. That would be of little moment were this a case of a "cunning device"[29] fashioned for the sole purpose of advancing the interests of those who invented it. But this is not that kind of a case.

Respondents' previous record is unblemished. And nothing in the materials before us suggests that their con-

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29. *Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 202 (1976) placed much stress on this phrase, which figured prominently in the legislative history of Section 10(b) of the Exchange Act.

tinued presence in the securities business is likely to endanger investors or the public interest. Hence we think censure coupled with the publication of this opinion enough to attain the remedial end that we have in view. Our objective is to warn persons of the serious juridical risks that they run whenever they enter into an arrangement that reroutes some portion of an investment company's brokerage dollars back to its managers.

We consider, however, that the type of conduct involved here has the potential for serious abuse. Consequently, we shall deal more severely in the future with infractions committed after the issuance of this opinion.

We recognize, of course, that there will be borderline cases. Those confronted by such cases should submit them to the staff of our Division of Investment Management either by way of a request for a no-action position or by way of an application for exemptive relief under Section 6(c) of the Investment Company Act.

An appropriate order will issue.[30]

By the Commission (Commissioners LOOMIS, EVANS and KARMEL); Chairman WILLIAMS and Commissioner POLLACK not participating.

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30. Respondents gain nothing from *Collins Securities Corporation v. S. E. C.*, 562 F. 2d 820 (C. A. D. C. 1977). *Collins* held that findings of violations in disciplinary proceedings must be based on proof that is "clear and convincing" when two elements are present: fraud and the imposition of a severe sanction. 562 F. 2d at 824, 825, n. 32. Neither factor is present here. In any event, the facts essential to our decision are undisputed.

The exceptions to the initial decision are overruled or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.